

Electricity Authority

Risk Management Review

Programme initiation document

Updated: 19.02.24¹

Background

- Wholesale market volatility has been observed since the Pohokura outages (2018), and is expected to continue in the transition to renewable generation (consistent with New Zealand reaching net zero by 2050).
- The Authority's Wholesale Market Review found spot prices reflect underlying supply conditions (at least to some extent).²
- Retail (mass) market customers remain largely on fixed price variable volume contracts; retailers must manage the risk of wholesale cost volatility and fixed retail prices.
- The transition to renewable generation will make it more difficult to supply hedge contracts; at the same time the associated increase in wholesale cost volatility will increase demand for risk management.³
- Non-integrated retailers say that:
 - Over-the-counter (OTC) risk management contracts are not available, not suitably shaped, or too expensive.
 - Four large gentailers⁴ (both competitors of the non-integrated retailers and suppliers of core risk management products to them) are also impacting competition via their internal transfer prices (ITPs) and retail pricing.

Programme purpose

Consumers have more choice and more access to affordable electricity in a competitive retail electricity market. The purpose of the Risk Management Review is:

- To test whether the availability of OTC contracts, in the context of other risk management options, is creating a barrier to entry or expansion in the retail electricity market, and therefore harming competition.
- Where the evidence indicates that there is a problem, to consider the policy options available in response.⁵

Proposed approach

¹ This programme initiation document is a living document, and will be reviewed as the Risk Management Review progresses through its investigation phase.

² Regular monitoring of spot prices against the trading conduct provisions continues to show that spot offer prices are consistent with Code obligations ie, that they reflect the offers that would be made in a competitive market.

³ Refer, for example, to Frontier Economics, *Future Financial Risk Management in the NEM: a report for the ACCC*, 16 November 2023 – [appendix-d-future-financial-risk-management-nem-frontier-economics-inquiry-national-electricity-market-december-2023-report.pdf \(accc.gov.au\)](https://www.accc.gov.au/inquiry-national-electricity-market-december-2023-report.pdf).

⁴ Contact, Genesis, Mercury and Meridian.

⁵ Noting that it is possible that OTC contract offers may be efficient, but still not be what non-integrated retailers are seeking.

The Risk Management Review is divided into two phases:

- Phase 1 - investigation
- Phase 2 - policy response.

Further detail on the objectives and proposed approach of each phase is outlined below.

Objectives – What does the programme aim to achieve in phase 1 (investigation)?

Retail market competition (context for assessment of risk management options)

1. Form and articulate a clearer view on what workable retail electricity market competition looks like – what is the role of different retailers in the market?
 - Includes:
 - Testing against other jurisdictions/markets
 - Testing against the Authority's statutory objectives
 - Considering competition over a range of timeframes.⁶

Accessibility

2. Assess the availability of risk management options, ie:
 - The availability of OTC contracts, including shaped products⁷
 - The availability of alternative risk management options (eg, demand response, batteries, generation/quasi-integration/PPAs, ASX, other business models) and the gaps that they fill.⁸

Pricing

3. Assess how OTC contracts are priced – does the pricing make sense given costs and external relativities?
 - Do OTC contract prices and terms appropriately reflect the costs of their components (including volatility, shape, locational factors, volume, credit risk)? Should they be priced at marginal cost (eg, cost of a battery), average cost, or opportunity cost?
 - How does the pricing of OTC contracts compare to the costs of potential substitutes (alternative risk management options listed above)?

Context

4. What are the drivers of accessibility and pricing, and how might they impact on retail electricity market competition now and in the future?
 - Includes considering:
 - The extent to which the transition to a low-emissions economy impacts accessibility or pricing,⁹ or our expectations of retail market competition or risk management options.

⁶ Noting economic regulation generally prioritises the long-term ie, dynamic efficiency.

⁷ As well as volume and shape, availability includes considering other terms of access, and the contracting process.

⁸ Includes considering market definition.

⁹ For example, is accessibility or pricing being driven by the increasing variability and intermittency of generation during the transition.

- Noting the dual role of gentailers in this context¹⁰, whether gentailer internal relativities (whether ITPs or other) raise competition concerns.

Objectives – What does the programme aim to achieve in phase 2 (policy response)?

Note phase 1 (investigation) will be followed by phase 2 (policy response).

Consider whether there are material problems identified in the investigation phase, and if so:

- Identify potential (proportionate) remedies; or
- Report to MBIE/the Government if the Authority does not have a fit for purpose remedial power.

As part of phase 2, the Risk Management Review will need to consider what interventions and policy levers are available to other agencies eg, the Commerce Commission.

While these phases are sequential, some preparatory work may be undertaken on phase 2 ahead of the conclusion of phase 1. This is to ensure that the Authority is well placed to quickly provide advice to the Board and implement any decisions.

Outcomes – the desired future state

- Consumers benefit from a competitive retail electricity market in which there are diverse products and services that meet their electricity needs and give them choice.
- The Authority and stakeholders have reasonable grounds to be confident that either:
 - Risk management options (in aggregate) are accessible and priced efficiently, and are not a significant barrier to workable retail competition; or
 - The Authority/other agencies/the Government are actively responding to any material problems relating to risk management options.
- The Authority and stakeholders are clear about the rationale for any relevant market development priorities and trade-offs, which have been properly articulated and tested.
- The Authority is better placed to monitor and promote retail competition, including having a more clearly articulated view regarding workable competition.
- Participants have a clearer understanding of the Authority's expectations of them.

Outputs and milestones

- These are yet to be confirmed. Note, they will be reviewed after the first iteration of phase 1 (investigation).
- Note that this programme will need to carefully balance urgency and robustness throughout its lifecycle, reflecting the importance of these issues to stakeholders.

¹⁰ Suppliers of OTC contracts and exchange based hedges, and also competitors in the retail electricity market.

Assumptions

- The Authority will remain the lead Government agency considering these retail electricity risk management issues.
- The Authority will have ongoing access to Commerce Commission competition expertise (economics, investigation).
- The Authority is able to overcome any information asymmetries through voluntary and statutory information gathering.
- The risk management review will remain a priority for the Authority, and will continue to be resourced accordingly (internally and, where required, externally).
- Access to exchange based hedges (ASX) for non-integrated retailers has been or will shortly be restored (through new brokers in the market) ie, that exchange based hedges remain a viable risk management option available to non-integrated retailers.
- The Authority's distribution reform programme will identify and address any material barriers to the development of flexibility services, so that demand side flexibility and batteries/storage become increasingly viable risk management options.
- Firm OTC contracts for peak hedging requirements will continue to be voluntarily offered by gentailers, consistent with the OTC code of conduct, during the course of this work programme.

Excluded from scope

- Consideration of the market for financial transmission rights.
- A full review of retail competition eg, a review of switching processes.

Interdependencies

- Hedging recommendations (8, 13, 24 and 31) to strengthen risk management and competition made by MDAG in its December 2023 final recommendations paper, [Price discovery in a renewables-based electricity system](#), and the Authority's response to these.
- Potential contribution to this review programme from related work: OTC code of conduct monitoring; hedge disclosure obligations; market making; ITP post-implementation review.

Appendix: Related and complementary projects

Project
Monitoring of OTC code of conduct
Hedge market enhancements: ASX access and commercial market-making
Improving hedge disclosure obligations: collection and publication of risk management information
Authority's response to MDAG's final recommendations paper on <i>Price discovery in a renewables-based electricity system</i> , particularly recommendations 8, 13, 24 and 31 to strengthen the hedge market
Retail data project
Post-implementation review of internal transfer pricing and retail gross margins disclosures
Updating regulatory settings for distribution networks
Improving consumer choice

The Authority will shortly publish its intended programme of work in response to MDAG's December 2023 recommendations, such as developing standardised 'shape' product(s), and subsequent contingent measures (eg, market making in caps or other shaped products).